SEC Requires Hedge Fund Managers to Register as Investment Advisers

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Introduction
The SEC recently adopted a new rule that requires most investment advisers that manage more than $30,000,000 and manage "private funds" to register as investment advisers with the SEC by February 1, 2006. The adopting release (Advisers Act Release No. 2333 [December 2, 2004]), including the dissent by two SEC Commissioners, the proposing release (Advisers Act No. 2266 [July 20, 2004]), and public comments on the proposed rules are available at www.sec.gov/rules/final.shtml.

The registration requirement applies whether an adviser is currently unregistered or is registered as an investment adviser with a state securities authority or as a commodity trading adviser or commodity pool operator with the Commodity Futures Trading Commission. An adviser with at least $25,000,000 but less than $30,000,000 under management may (but is not required to) register with the SEC. An investment adviser with less than $25,000,000 of assets under management remains subject to state investment adviser regulation, and is prohibited from registering with the SEC, even if that adviser has 15 or more clients (exceptions from this prohibition are provided for advisers to mutual funds, pension consultants and certain other types of advisers).

Rule Amendment
Advisers Act section 203(b)(3) generally exempts an investment adviser from investment adviser registration if it (1) has had fewer than 15 clients during the preced-
ing 12 months and (2) does not hold itself out generally to
the public as an investment adviser. Advisers Act Rule
203(b)(3)-1 previously counted a hedge fund as a single
client for purposes of the “fewer than 15 clients” test
above. Under the amended rules, however, an adviser to a
“private fund” must count each of that fund’s investors
as a client.

Non-U.S. advisers that manage non-U.S. private funds
only are also subject to the look-through provisions (and
thus may be required to register as investment advisers
with the SEC), except that only U.S. investors count toward
the 14-clients limit. Those advisers are exempt from many
of the provisions of the Advisers Act.

Definition of “Private Fund”
A private fund is an entity that has all three of the
following characteristics:

1. The entity would be an investment company under the
Investment Company Act but for the exception
provided from that definition by section 3(c)(1) or sec-
tion 3(c)(7) of that Act. Sections 3(c)(1) and 3(c)(7)
both require that a fund not make or propose to make
a public offering of its securities. Section 3(c)(1) limits
to 100 the number of beneficial owners of the fund’s
securities. Section 3(c)(7) limits sales of the fund’s
securities to qualified purchasers.

2. The entity permits redemptions of ownership interests
in the fund within two years of purchasing those
interests for all new investments on or after February 1,
2006. The SEC adopted this two-year lock-up require-
ment to exclude private equity and venture capital
funds from the private fund definition while capturing
most hedge funds within it. To avoid SEC registration,
some advisers to hedge funds are now considering
amending their fund documents to impose two-year
lock-ups. The SEC has warned, however, that it will
monitor whether the two-year lock-up requirement is
effective in distinguishing hedge funds from private
equity and venture capital funds.

The new rules permit redemptions during the lock-up
period due to “extraordinary” events, which include,
for example, when it becomes impractical or illegal for
an investor to continue to hold the interest; when
redemption is necessary to avoid materially adverse
tax, regulatory or ERISA consequences; when an
investor dies or becomes disabled; and when key
personnel of the adviser die or become disabled. An
adviser may not, however, use side letters to circum-
vent the two-year lock-up; the SEC has stated that a
hedge fund whose documents require a two-year lock-
up but that enters into side letters with some investors
allowing them to redeem within two years will be
treated as a private fund. The new rules permit
redemption during the lock-up period of interests
acquired through reinvestment of distributed capital
gains or income. The SEC allows an adviser to deter-
mine the age of capital contributions to its hedge fund
on a first-in, first-out basis.

3. The entity’s interests are offered based on the ongoing
investment advisory skills, ability or expertise of the
investment adviser. The SEC adopted this element to
confirm the direct link between the fund manager’s
advisory services and investors’ decisions to invest in
the fund. The adopting release does not provide an
example of what types of funds would be excluded by
this element of the definition of private fund.

An offshore hedge fund with all three characteristics is
also a private fund, and each investor in that fund
(whether a U.S. or non-U.S. investor) is counted toward
the adviser’s 14-clients limit. Nevertheless, the rule
excludes from the definition of private fund a fund that
(a) has its principal office and place of business outside
the U.S. and (b) makes a public offering of its securities
in a country other than the U.S. and is regulated as a
public investment company by that country.

Other Rule Amendments
The SEC also adopted several related Advisers Act rule
amendments with varying compliance dates.

- Rule 204-2 requires an SEC-registered investment
adviser to keep records that support its performance
advertisements. The rule has been amended to allow an
investment adviser that was exempt from SEC registration, but is now required to register under the new rule, to continue to market its performance if it retains all required records relating to periods after February 10, 2005, and any existing records demonstrating its performance prior to that date.

- Rule 204-2 now clarifies that the books and records of an SEC-registered investment adviser include the books and records of a private fund for which it (or any related person) acts as the general partner, managing member or in a comparable capacity. The records of the private fund will therefore be open to SEC inspection.

- Rule 205-3 allows an SEC-registered investment adviser to charge a performance fee or allocation only to a “qualified client” (generally, an investor with a net worth of $1,500,000, an investor with at least $750,000 under the investment adviser’s management, a non-U.S. investor, a qualified purchaser for purposes of Investment Company Act section 3(c)(7), or one of several specified managers or employees of the investment adviser). To avoid requiring investors who are not qualified clients in private funds to divest their interests in those funds, Rule 205-3 now allows an investment adviser to continue to charge a performance fee or allocation to any such investor who invested in a private fund before February 10, 2005. Such investors also may make additional investments. Generally, an SEC-registered investment adviser must “look-through” any hedge fund that relies on section 3(c)(1) to determine whether each underlying investor is a qualified client. As noted in Advisers Act Release No. 2333, note 221, however, the SEC will allow an investment adviser to charge a performance fee to an offshore fund, whether or not that fund has U.S. investors.

- Schedule D of Part 1 of Form ADV now incorporates questions regarding the name, minimum investment commitment, current value of assets and other information about each private fund that an investment adviser or its related person manages. Any SEC-registered investment adviser that amends its Form ADV (and any adviser that submits its initial Form ADV in connection with an application for SEC registration) after that date must answer the new questions. Many advisers already disclose most of this information on Schedule D about U.S.-based hedge funds they manage, but an adviser must now also identify offshore private funds to which the adviser acts solely as an investment adviser (and not a general partner or manager).

### Timing of Registration

Investment advisers that are required to register with the SEC under the new rules should begin that process soon. It may take at least several months to develop and implement compliance policies and procedures that meet the standards that the Advisers Act imposes on SEC-registered advisers. The SEC has routinely been approving new SEC registrations within one or two weeks, so an adviser should begin complying with all of the SEC rules when submitting the Form ADV. If hedge fund managers flood the SEC with registration applications, the SEC’s turnaround time may increase, so an adviser should submit its Form ADV online by early December 2005, to ensure that the SEC declares the registration effective by the filing deadline, February 1, 2006.

SEC staff members have suggested that the SEC may adopt a new Part 2 of the Form ADV in the coming months (although there is no guarantee that it will do so). An investment adviser may want to consider this suggestion before applying for SEC registration.

### Background of the New Rules

The new rules implement the SEC staff’s recommendations in a September 2003 report, which was the culmination of the SEC staff investigation of hedge funds. In the proposing release, the SEC cited five principal reasons for the proposal: (1) collection of necessary data regarding private funds and their advisers; (2) deterrence and early detection of fraud; (3) ability to prevent unfit persons from managing private funds; (4) adoption of compliance controls for the protection of investors; and (5) discouraging “retailization” of hedge funds by requiring that each investor in a private fund be a qualified client.
The SEC voted three to two to adopt the rule, and the two opposing commissioners dissented in writing. Most commentators do not object to the aim of gathering more information about hedge funds. The two commissioners’ dissents, objections raised by public officials (Alan Greenspan among them) and comments submitted to the SEC generally made some or all of the following objections, among others: (1) the rule will not elicit useful information; (2) evidence does not support an argument that disproportionate fraudulent activity occurs among hedge funds; (3) SEC registration is unlikely to detect or deter fraudulent activity, given the infrequency of SEC examinations; (4) the cost of additional SEC resources and expertise to regulate the additional 700 to 1,200 private fund advisers that the SEC staff has estimated will be required to register is outweighed by the unproven benefit of regulation, especially given the relative sophistication of hedge fund investors; (5) registration does not involve determination whether an investment adviser is unfit; and (6) the evidence of significant retailization is at best sparse.

Other Implications of SEC Registration
Investment advisers to private funds that are not currently SEC-registered will become subject to a number of significant requirements:

Form ADV
An adviser that is not currently required to file a Form ADV will need to complete the form and offer to distribute Part II to current and future investors in its hedge funds (and to its separate account clients). Form ADV was not designed with hedge fund advisers in mind, and many of its questions create frustrating, if not fascinating, imponderables in the hedge fund context. The SEC’s proposed overhaul of Part II of Form ADV may not address the relevant issues and may result in substantially greater burden in completing and updating the form.

Custody Rule
An SEC-registered adviser must maintain each hedge fund’s assets (and the assets of the adviser’s other clients) with a qualified custodian and notify the fund’s investors where those assets are held. Unless the hedge fund distributes annual financial statements audited in accordance with GAAP within 120 days of the end of the fund’s fiscal year, an SEC-registered adviser must also arrange for the fund’s account statements to be sent to the fund’s investors. The new rule also allows the manager of a fund of hedge funds to distribute those audited financial statements within 180 days of the end of the fiscal year of the fund of hedge funds. State-registered or unregistered advisers that currently follow the Bennett and PIMS line of SEC no-action letters may no longer rely on those letters to avoid the custody rule if they become SEC-registered. Thus advisers that become registered in 2005 will need to prepare the 2005 audited financial statements of their hedge funds no later than April 30, 2006, to take advantage of this special rule.

Policies and Procedures
The SEC has promulgated numerous rules that require advisers to maintain specific policies and procedures regarding, among other things, prevention of insider trading, privacy, proxy voting, compliance programs and codes of ethics. Every SEC-registered investment adviser must adopt and implement policies and procedures that address, at a minimum, all of the following issues and must have a chief compliance officer who oversees those policies and procedures:

- a code of ethics designed to prevent fraud by firm personnel, which also addresses the firm’s standard of business conduct, compliance with federal securities laws (which may include a fairly extensive discussion of the specific laws, rules and regulations applicable to the adviser,
its employees and any funds it manages),
personal securities reporting, pre-approval of
certain transactions and reporting of violations
of the code of ethics;
- prevention of insider trading;
- proxy voting;
- portfolio management processes, including
  allocation of investment opportunities among
  clients and consistency of portfolios with
  clients’ investment objectives, disclosures by the
  adviser and applicable regulatory restrictions;
- trading practices, including procedures by
  which the adviser satisfies its best-execution
  obligation, uses client brokerage to obtain
  research and other services and allocates
  aggregated trades among clients;
- proprietary trading of the adviser and personal
  trading activities of supervised persons;
- the accuracy of disclosures made to investors,
  clients and regulatory authorities, including
  account statements, advertisements and
  published prior performance;
- safeguarding of client assets from conversion
  or inappropriate use by advisory personnel;
- the accurate creation of required records and
  their maintenance in a manner that secures
  them from unauthorized alteration or use and
  protects them from untimely destruction;
- marketing practices, including the use of
  solicitors;
- procedures to value client holdings and assess
  fees based on those valuations;
- safeguards to protect the privacy of client
  records and information; and
- business continuity plans to protect client
  interests if the adviser becomes unable to
  provide advisory services (for example, after a
  natural disaster).

Recordkeeping Requirements
SEC-registered advisers must keep myriad
financial, trading, marketing, and client relations
policies and procedures and general records, in
most cases for at least five years and in some cases
indefinitely.

SEC Examinations
SEC examinations are typically conducted by
sophisticated and knowledgeable inspectors
over a number of days or weeks. Based on SEC
staff reports, speeches by SEC staff and SEC staff
examination requests, the SEC staff is familiar
with and likely to scrutinize some or all of the
following hot-button issues: (1) soft dollar
practices, especially those that do not meet the
safe harbor provided by Exchange Act section
28(e); (2) best execution, including whether the
investment adviser periodically reviews execu-
tion quality and cost and whether it documents
that review; (3) trade allocation policies and
practices, including whether the adviser delays
allocating trades among the adviser’s accounts,
discriminates among clients (for example, by
allocating new issues to accounts that pay the
adviser a performance allocation) or misappro-
priates client opportunities; (4) trade error
policies and practices, to ensure that advisers
correct errors rapidly, do not use client assets
(including soft dollars) to correct trading errors
and do not discriminate among clients (for
example, a client with better performance
should not be allocated an error); (5) perfor-
mance advertising policies, practices and
documentation; and (6) valuation policies and
procedures. An adviser that intends to register
with the SEC should consider engaging a
compliance consultant, well before its SEC regis-
tration becomes effective, to conduct a mock
examination of its business to identify any areas
where its existing policies and procedures fall
short of SEC requirements.
Marketing and Past-Performance Disclosure
SEC-registered advisers are subject to several rules and a number of interpretations that regulate their marketing and disclosure of their past performance.

Some Significant Benefits
SEC registration does have significant benefits:
- Unlike an adviser that is not registered with the SEC or a state, an SEC-registered adviser can hold itself out to the public as an investment adviser. Public offerings of an adviser’s hedge funds are still prohibited, unless the funds themselves are registered with the SEC. The SEC’s adopting release clarified that the disclosure in Part 1 of the investment adviser’s Form ADV that the adviser manages a private fund does not render unavailable the private placement exemption for interests in that fund.
- Some larger ERISA plans might be more likely to invest in hedge funds managed by SEC-registered or state-registered advisers, because, under certain conditions, trustees of ERISA plans may be exempt from co-fiduciary liability for acts or omissions of such advisers.
- An SEC-registered adviser may be able to exclude assets held in a client account (such as a hedge fund) from its own holdings for purposes of determining whether it has 10% beneficial ownership of an issuer’s class of securities under the reporting and short swing trading provisions of Securities Exchange Act section 16.

Action Required
This memorandum provides only an overview of some of the key issues relating to the new SEC registration rule. Advisers to hedge funds should review their operations soon to determine what steps, if any, are required to comply with the new regulatory regime.

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